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SUBJECT: DIVISIONS BETWEEN GOA AND RESERVE BANK OF AUSTRALIA?

Classified By: ECONOMIC COUNSELOR EDGARD KAGAN FOR REASONS 1.4 (b/d).

[11](#). (U) This is joint ConGen Sydney and Embassy Canberra cable.

Summary

[12](#). (C/NF) The Reserve Bank of Australia has acted aggressively over the last six months to address deteriorating economic conditions by slashing the cash rate from 7.25 percent to 3.25 percent. Prime Minister Rudd and Reserve Bank Governor Glenn Stevens have publicly credited the aggressive rate cuts together with two large fiscal stimulus packages with preventing the Australian economy from spiraling into the recessionary territory experienced by other industrialized economies. Yet, reserve bank officers and treasury officials have intimated to us recently that the Reserve Bank is "truly undecided" whether to go full throttle on interest rate cuts or hold its fire, in part because Reserve Bank Board members have differing outlooks for the economy over the next year. Contacts confirm that the Reserve Bank and federal government have coordinated closely on policy actions in recent months, but complain that the RBA is taking too cautious an approach and missing the opportunity to help reduce the impact of a recession. This is the first sign of a real divergence between the RBA Government (represented on the RBA Board by highly respected Treasury Secretary Ken Henry) since the Rudd Government took office in November 2007. The monthly Reserve Bank meeting April 7, which will determine the cash rate for the coming month, should signal whether it intends to remain aggressive or adopt a more conservative approach. End Summary.

Australian Economy: How Bad Will it Get?

[12](#). (C/NF) Plummeting global trade, steep fourth quarter contractions in Japan, Korea, and Taiwan, and a significant fourth quarter slowdown in China have convinced most Australian economists that the country is probably already in recession. The debate has shifted to how deep and how long a recession Australia will endure, with the biggest variable being the extent of the global downturn and its impact on demand for commodities. According to forecasts by Westpac and Commonwealth Banks (two of Australia's "big four" banks) Australia will emerge from a mild recession (contracting by 1

percent or less) in the second half of 2009. These forecasts point to a strong housing market, stimulated by government subsidies for first-time homebuyers, and larger fiscal stimulus as measures that will buoy the economy until global demand recovers. The chief economist at each bank, however, admitted to us on April 2 that these forecasts heavily lean on the assumption that China will recover in the second half of 2009 -- an assumption that made them more uncomfortable by the week. Reserve Bank board member Warwick McKibbin has indicated to us in recent weeks that he shares the view that China will recover in the second half of 2009, which will pull Australia out of recession in the same time frame. In contrast, Reserve Bank Assistant Governor for Economics Malcolm Edey told EconCouns and ConGen Poleconoff April 2 that he believes the current recession will be worse than Australia's recession in the early 1990s, which lasted for five quarters and led the economy to contract by a total of 1.25 percent. He warned that Australian recessions average five to six quarters and indicated that the current recession would likely lead to an overall contraction of 2.0 percent.

Reserve Bank: Undecided

13. (C/NF) In our April 2 meeting with Edey, he admitted that the Reserve Bank was "truly undecided" a week out from its April 7 monthly Board meeting on whether to continue aggressive interest rate cuts. There was broad agreement among the Reserve Bank Board, Edey explained, to bring interest rates down to an expansionary setting of 4.25 percent before the end of 2008. Although the Board had intended to wait a few months for the new expansionary rate to flow through the economy, Edey said the Board agreed that further deterioration in the global economy merited another aggressive cut in February. The Board decided to pause on cuts in March, in part to give the Reserve Bank enough ammunition down the road in case the economy spirals into deeper recession. Edey said that the Board was by no means committed to this approach, pointing out that recent statements by Reserve Bank officials were deliberately worded with a mixed assessment of the economic outlook to give the Board maximum flexibility to determine monetary policy strategy at the April 7 meeting. He said the members of the Board would have to debate whether they are prepared to take the interest rate to "zero," like the U.S. Federal Reserve, or to continue to hold fire.

PM's Advisor: Better Too Much Than Too Little

14. (C/NF) Steven Kennedy, Chief Macroeconomic Advisor to PM Kevin Rudd, told us April 1 that he and his Treasury Department colleagues are increasingly frustrated with the RBA. Praising the Bank's initial response to the global financial crisis, Kennedy said that the RBA's aggressive approach helped reassure markets and complimented the Government's stimulus packages. He complained that the RBA is "schizophrenic" in that the Banks simultaneously believes that Australia will be hit hard but that it should hold off on further rate cuts in order to "keep its powder dry" in case things get worse. Kennedy argued that the RBA's cuts to date have had considerable impact and that it should do more while its actions have traction in the real economy. Waiting to see what happens runs the real risk that by the time the RBA decides to move, the economy will have deteriorated so much that further interest rate cuts may not have much of an impact. He stressed that the PM would much prefer the Bank and the Government to have to take rapid action to compensate for doing too much than take corrective action after doing too little. Kennedy suggested that RBA Deputy Governor Ric Battelino and other members of the RBA Board have been swayed by McKibbin's argument that the current economic slowdown is more likely to be similar to the 1997 Asian Financial Crisis in which Australia was largely spared the full impact of the downturn in what had been key markets. Kennedy argued that McKibbin could be right, but that the preponderance of evidence is that the current downturn will be much worse. He

said that some RBA Board members are leery of appearing to be too close to the Government for fear that they will be blamed for turning a blind eye to excessive deficit spending.

Comment

15. (C/NF) A more cautious approach by the Reserve Bank would represent a divergence from PM Rudd's aggressive response. Rudd will have to defend Australia's first federal budget deficit in eight years, when he release the budget in May. Fiercely independent, the Reserve Bank will set its course irrespective of political consequences, but its decision will shape the Prime Minister's rhetoric over the next two months.

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